DOW THEORY LETTERS INC.

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THE MARKET: Spearheaded by the twin phalanxes of rising Vietnam expenditures and soaring auto sales, businessmen, economists and Administration spokesmen have made so bold as to jump the gun on the normal "yearend forecasts." The crystal ball gazing started as early as October this year, and the widely held prediction is for "continued economic expansion through the first half of 1966" with many forecasters being optimistic for a rising economy throughout 1966.

Perhaps the single hedge in the predictions revolves about the spector of rising interest rates. This phenomenon has already resulted in a continuous barrage of "requests" and "urgings" from official sources admonishing businessmen (i.e., bankers) against "reading too much" into the statistics before joining the bandwagon of higher rates. The late Bernard Baruch, when questioned about economics, replied: "Economics is supply and demand. Everything else is the bunk." Following Baruch's law, interest rates have continued to creep higher (see later section).

As far as the forecasts are concerned, Dow Theorists are likely to be little influenced by them. Most of us have learned to ignore the predictions of individuals, no matter how "expert," and to concentrate the bulk of our attention on the movements of the Averages and the fundamental Dow Theory concept of "values."

From the technical standpoint, there were some signs last week of an increase in caution among large interests and a simultaneous decrease in caution on the part of the public. Such gauges as the Confidence Index and the big block transactions (see Composite Chart) suggest that if nothing else, "big money" is concerned about the shrinkage in equity values and is moving towards safety. At the same time the odd-lot ratios, having held in the heavy selling area for many months, moved last week towards equilibirum (i.e., as many shares purchased as sold), indicating a lessening of skepticism as far as the public is concerned. Over the past few weeks the average price of "the 20 most active stocks" on the N.Y.S.E. dropped into the $37 area (average price over the past two years, $45), and volume on the speculative Amex rose sharply relative to N.Y.S.E. volume.

What does all this mean in terms of the current situation? In this writer's opinion, such observations constitute "a yellow flag" for the investor, but it is also true that almost all major trouble in past market history has been preceded by danger signals in the pattern of the Averages. So far, with both components rising to new highs late last week, it must be stated that the Averages have given no hint to suggest that the advance is over.

Both William Hamilton and Robert Rhea noted that it is exceedingly difficult to call the end of

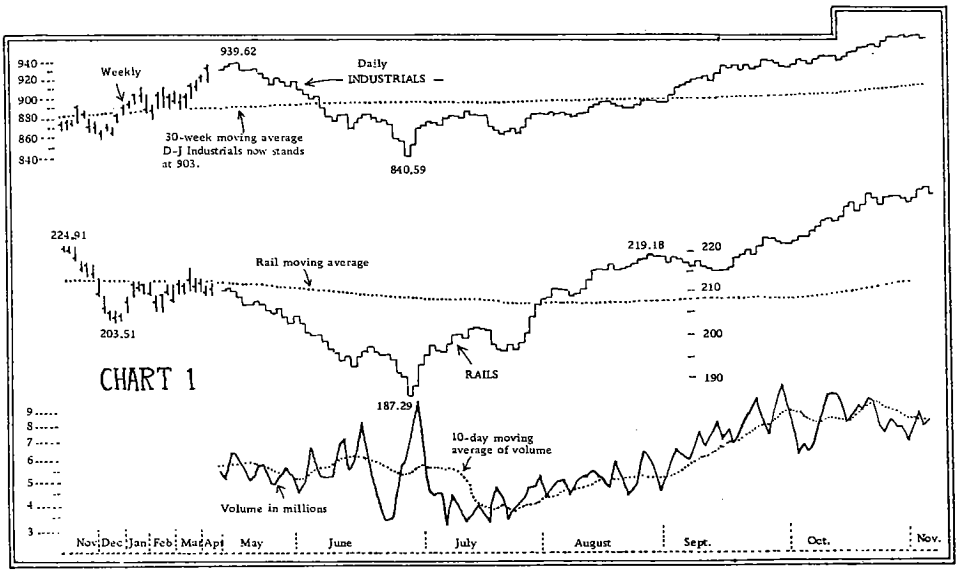
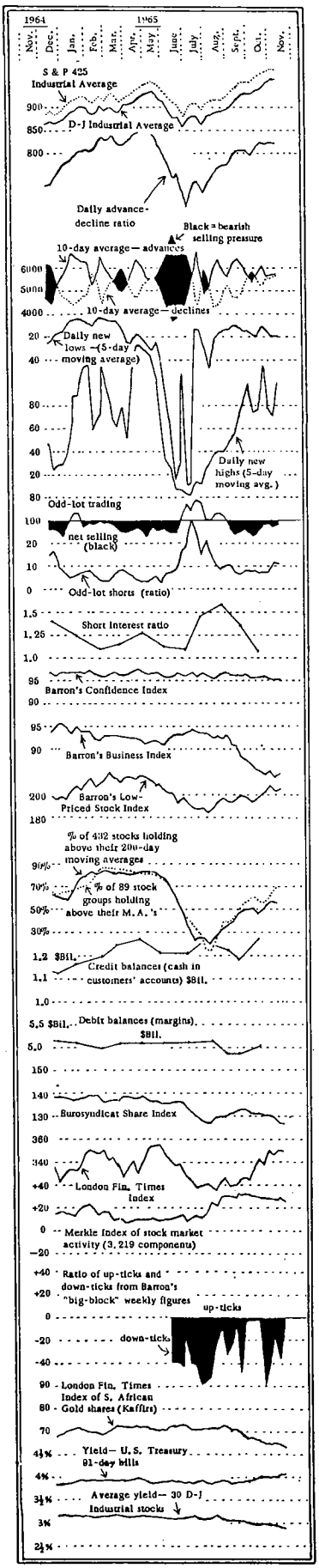


CHART 1


1964
1965
S & P 425 Industrial Average
D-J Industrial Average
Daily advance-decline ratio
Black = bearish selling pressure
10-day average — advances
10-day average — declines
Daily new lows (5-day moving average)
Daily new highs (5-day moving avg.)
Odd-lot trading
net selling (black)
Odd-lot shorts (ratio)
Short interest ratio
Barron's Confidence Index
Barron's Business Index
Barron's Low-Priced Stock Index
% of 482 stocks holding above their 200-day moving averages
% of 89 stock groups holding above their M.A.'s
Credit balances (cash in customers' accounts) $Bil.
Debit balances (margins) $Bil.
Barosyndicat Share Index
London Fin. Times Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's "big-block" weekly figures
up-ticks
down-ticks
London Fin. Times Index of S. African Gold shares (Kaffirs)
Yield — U.S. Treasury 91-day bills
Average yield — 30 D-J Industrial stocks

a great bull market, and they both were necessarily vague in describing the actual symptoms which might foretell of the patient's demise. One comment by Hamilton which has always stuck in my mind is as follows: he noted that a major top is most likely to occur in an area where ..."the edifice of speculation has been constructed sufficiently high for it to make a noise when it topples over." With the yield on the broad S & P 425 Industrial Average now at a miniscule 2.81%, few veteran observers can doubt that we are steadily approaching the point where Hamilton's "noise" is likely to be sounded. Conclusion: The primary and secondary trends are bullish with the minor trend obscure and possibly turning down.

The Composite Chart shows the two leading industrial averages at their all-time highs. It has been 6 months since the May peak in the A-D ratio, and it is becoming pointedly obvious that this indicator is now lagging behind the industrial averages. Confirming this is the fact that new highs (5-day avg.) have never come back to their April-May level. A deterioration in odd-lot figures is evident and was discussed on Page 1. Barron's Confidence Index held at its 19 months low of 95.2 last week. Of 89 leading stock groups, 70% are now holding above their moving averages, while only 54% of the individual stocks are holding above their moving averages. However, both indicators are bullishly above the 50% critical level. The Eurosyndicat index (100 leading Common Market corporations) is heading down, is now 127. The Merkle Index has retreated to plus 25 (still bullish), and Barron's big block studies shows minus 8 for this week, a continuation of the distribution. The Kaffirs gold index dropped to 63.8, and I particularly recommend Western Areas (bid price 3.25) at this time. Conclusion: The indicators are presenting a "mixed" look, with many of the monetary and long-term indices suggesting the need for caution.

VOLUME: Volume is one of the most talked about but least understood subjects in Wall Street. William Hamilton in his famous Dow Theory editorials was contradictory about volume implications, or rather he changed his mind about volume as time passed. Thus, in his early editorials Hamilton gave volume less consideration, and in fact he wrote in 1913: "....it should be said that the price average by its very nature discounts everything. Dullness and inactivity are but symptoms, and for these the Averages allow, as they do likewise for activity, unexpected news, dividends and everything else contributing to make up the fluctuating market price. This is why the volume of trading is ignored in these studies."

But despite his belief that the Averages discount everything (including volume), Hamilton did offer frequent comments in which volume implications were taken into consideration. For instance, "One strong feature of the advance is that volume of trading has increased with each successive daily gain...." (1911). As early as 1909 Hamilton wrote: "On the recession the market has become dull and narrower."

Robert Rhea gave much more attention to the subject, and he seldom wrote a piece without adding some reference to volume. Rhea often called attention to the fact that important bear market bottoms were usually accompanied by dull volume. In a letter of correspondence with Hamilton in 1921 (the beginning of the 1921-29 bull market) Rhea wrote that they both agreed that "dull volume, sideways movement, the market's indifference to bad news, and failure to rally were all indications that the worst was over..." Rhea noted on several occasions that the volume near a bear market bottom was generally about 10% of that which has appeared at the preceding bull market top. In other words, markets that were listless and dull, following major declines, were usually the "safe" investment markets, and these were the kinds of markets which Rhea liked to make large commitments in.

On the other hand, Rhea stated: "I am prone to be right too soon in the third phase of a bull market. Diagnosis might be improved if all could agree on how hot is hot." In other words, when the market heated up and speculation was rampant, Rhea tended to beat an early retreat. In April, 1935, in the face of a listless market, Rhea attempted to steady the nerves of his subscribers when he wrote: "I know of no genuine liquidating market of past years that has developed unless preceded by an era of excessive speculation and expanding earnings."

In the broadest sense, the volume implications at the extremities of a bull market are most fascinating. Consider these statistics. In 1942, following a three year decline, with the Dow selling between 10 to 13 times earnings, with average yields on the Dow at 7.5 to 7.9%, volume for the total year 1942 came to 125 million! Thus, at one of the greatest periods of undervaluation in modern history, N.Y.S.E. transactions were pitifully small. Again, in 1949, following a three year decline, with the Dow selling at 6.8 to 8.5 times earnings (!), with average Dow yields of 6.7%, volume for the total year (1949) amounted to 272 million. And this at the very onset of the greatest bull market in history. The public and the speculators could not have been less interested in the market during this period of great undervaluation.

Now take the year 1965. The bull market has been in effect for 16 years. The Dow is selling for roughly 18.5 times boom time earnings, and average yield on the Dow (including cash and extras) are 3.28%. In this era of overvaluation we find the public and the speculators vitally interested in the market. For in the six-week period starting September 16 transactions on the N.Y.S.E. amounted to 218 million shares. This was considerably more than the total trading volume of 1942 and not much under the total volume of the year 1949.

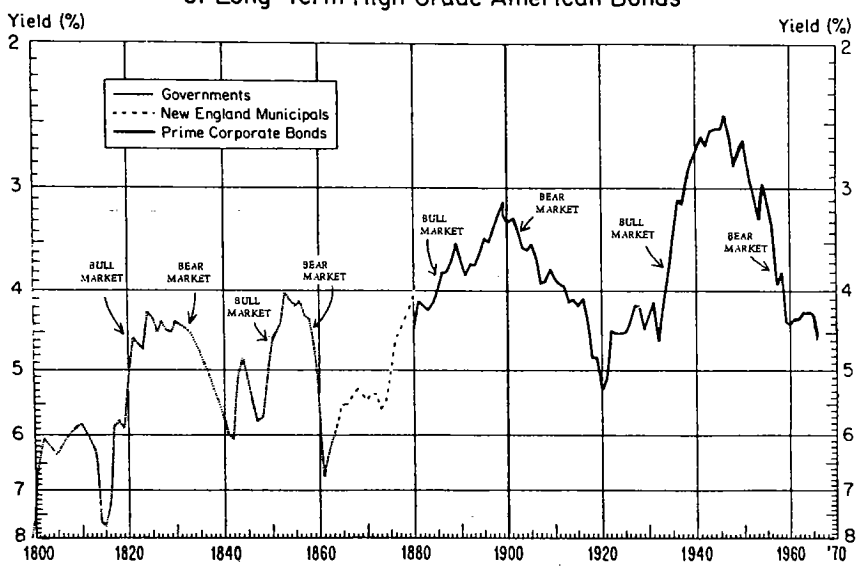
Conclusion: When stocks are great values the public and the speculator are apt to be singularly disinterested. When stocks are overvalued and prices have been rising for a number of years, the public and the speculator are apt to be extremely interested. Volume in its broadest sense can be an excellent gauge of total public and speculative interest.

QUESTION: Russell, have you changed your policy as far as long-term investment policy is concerned?
ANSWER: No, I continue to feel that the long-term investor should be largely out of the stock market and in 91-day Treasury bills and gold shares to the proportion of roughly 85% bills to 15% gold shares.
QUESTION: But what about inflation? Everywhere I turn I hear inflation talk plus warnings about the erosion in buying power of the dollar. How can I hold cash under these conditions?
ANSWER: First, over any given period of a year or so the possibility of serious inflation is quite limited. And if there is to be say a 1% inflation in the next year this is not going to be disastrous to the holder of cash. Furthermore, the current trends of interest rates, commodity prices and world markets do not suggest that any real inflation is enveloping us. As a matter of fact, this writer keeps charts of world commodity prices (statistics from the London Economist), and each chart shows current prices and percentage changes from a year ago (the latter is actually a momentum index). The four groups charted are Food, Fibers, Metals and All Items. This week's changes from a year ago are as follows: Food minus 11.3, Fibers minus 1.8, Metals minus 1.7 and All Items minus 7.0. These figures can hardly be construed as inflationary, and one might, in fact, infer quite the contrary. Certainly these world trends in key prices are running counter to any inflationary trends in prices and wages here. I continue to feel that the great danger ahead is not inflation but deflation. As I stated before, the problem of inflation over any one-year period is not serious; the problem of deflation could, on the other hand, be major during the period of the next year.
QUESTION: What case for long-term caution can be made in the face of current glowing business reports which are coming in from all quarters? Don't these reports suggest the wisdom of holding common stocks?

ANSWER: It might be well to note that the glowing business reports constitute the external or obvious side of the business picture. But just as technical analysis often portrays the underlying conditions of the stock market, so bank credit (see Letter 301) studies can illuminate the sub-surface aspect of the economy. The bank credit studies continue to show deterioration. For instance, the latest Bolton Tremblay Bank Credit Analyst points out that debits (total transactions across the nation) slowed in September (despite booming stock market volume and despite the Vietnam war!) while commercial and industrial loans continued to expand. This resulted in a further drop in the barometric debit/loan ratio. Furthermore, turnover of demand deposits in N.Y.C. declined for the third month in a row. As Bolton puts it, "Developments in the last month tend to increase rather than decrease the cautionary indications of the banking figures. There has been further slow deterioration."

BONDS & MONEY: Great bull or bear markets usually carry further than anyone believes possible. They usually end at a time when everybody believes that such an event is well nigh impossible. This is as true in the money (bond) market as it is in the stock market. For instance, only a few months ago, in the July/August issue of the authoritative Financial Analysts Journal, a money expert started his article ("The Outlook for Interest Rates") as follows: "The big story on the outlook for interest rates is that the long term trend of long and short term rates in the Western World will be down moderately....." That prediction was rendered incorrect only four months later.

Inverted Yields
of Long-Term High Grade American Bonds



One of the most important economic trends of this generation may now be entering its most dramatic phase. The event I am referring to is the probable final phase of the 19 year old bear market in bonds. Few investors are aware that the bond market tends to follow massive bull and bear trends in much the same way as does the stock market. But where most bull and bear markets in stocks have lasted 3 to 5 years, the cycles in bonds have tended to last considerably longer.

Note on the accompanying chart that a bull market in bonds was in effect from 1799 to 1810, a period of 11 years. A bear market then continued from 1810 to 1815. A 10 year bull market carried to 1825, followed by a 17 year bear market to 1842. A new bull market extended to 1853 (11 years), and a bear market terminated in 1861 (8 years).

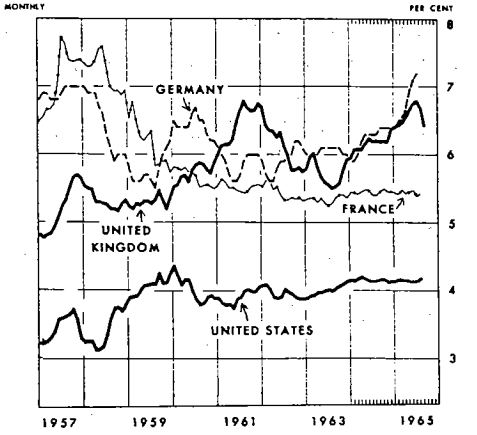
From the period of the Civil War to the present, bond movements were characterized by even greater and more prolonged swings. A 40 year bull market in bonds lasted from 1860 to 1900. A 20 year bear market reached into 1920, and a subsequent 26 year bull market extended to 1946. A major bear market started in 1946, and here is the point I want every reader to understand — nothing on the chart suggests that the bear market which started in 1946 in bonds has ended.

It is well to note that the last two drastic bear markets in stocks, the 1929-32 and 1937-38 bear markets, occurred within the context of a continuing bull market in bonds (see chart above). Thus, the bond market and the money markets were actually bolstered during those two periods by a bull market in fixed securities. However, at the present time, any bear market in stocks will occur within the framework of a continuing bear market in bonds. This could produce results which may only be "speculated upon" at this time. But one thing which I believe it will produce is the greatest bargains in fixed-rate securities in perhaps 100 years.

How does all this affect the long-term investor, and what can he do about it? My answer is that the investor should remember that the continuing trend of Government, State and City and Municipal deficit spending coupled with huge corporate and individual spending is producing two effects: (1) a certain monetary inflation in that a great amount of credit is being generated, (2) a potential deflationary monster, which is now showing its head in the form of rising interest rates. I believe that the full force of the coming deflation will fully express itself during the next downturn in the stock market and the economy. The deflation will be particularly acute because international monetary pressures will not allow our Government to "reflate" with lower interest rates as was the case in 1953, 1957, 1960 and 1962. The coming deflation will be extremely persistent and difficult to cure because of the acute credit situation throughout the country. Credit outstanding in this nation is now so massive that any drop in national income could produce "unexpected" strains in the ability of borrowers to continue their debt repayments (debt changes slowly but income can fluctuate sharply and rapidly). Such a predicament could produce unprecedented demands for money (to service the outstanding debt). This situation is undoubtedly the reason (consciously or unconsciously) why the Administration now

seems to harbor such a dread of anything resembling economic recession.

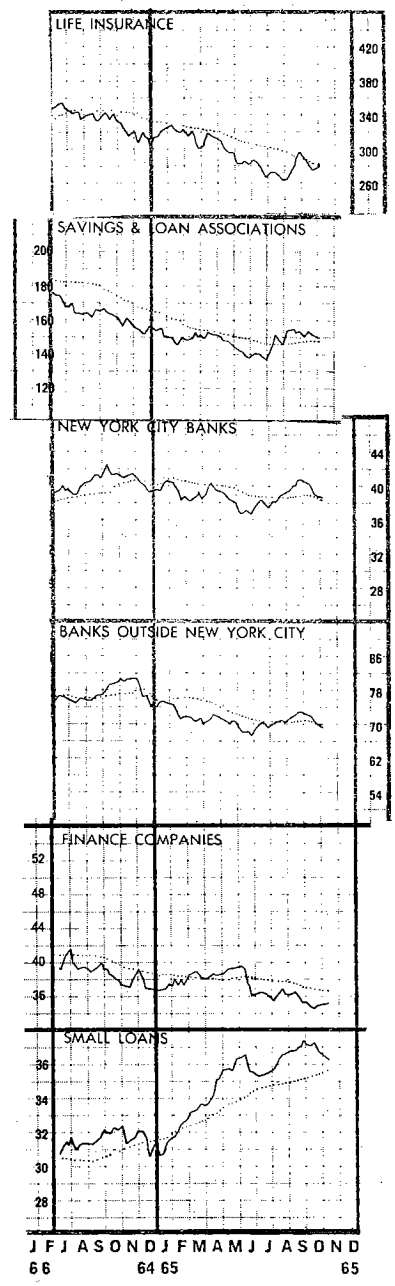
LONG-TERM INTEREST RATES IN SELECTED COUNTRIES



At the present time I feel we are approaching the financial point of no return. It is taking more and more money to keep the boom afloat. And the money markets are showing the strain. For instance, last week the yield on the (tax free) D-J Municipal Bond Average rose to 3.51%, highest rate since 1961. During the same week the yield on the bellwether 91-day U. S. Treasury bills rose to 4.09, highest in 5½ years. Longer-term Treasury bonds sank in price, thus affording the highest yields since early 1960 (last week 15 of the 40 listed U. S. treasuries provided yields of 4.40% or better). Meanwhile, two factors continue to exert added pressure on our money market. One is the great disparity between "cheap" money rates in the U. S. and high money rates abroad. The chart of long-term interest rates offers dramatic insight into this situation. A second source of pressure was foreseen for our money when it was announced (last week) that bond issues totaling over $3 billion were placed before voters across the nation. This was the greatest amount of debt securities ever put before the country in a non-election year. The implications of all this for the stock market should not be overlooked. Last week the spread between the yield on S & P's Aaa bonds (4.55%) and the yield on the S & P 425 Industrial stock Average (2.81%) was 1.74, the greatest such (adverse) yield spread in history.

STOCKS: I received many Letters during the past week pertaining to stocks which come under the 50% rule (as described in Letter 304). Most subscribers wanted a complete listing of stocks that were technically vulnerable under the 50% rule interpretation. Following is a fairly complete list of N.Y.S.E. issues: Ampex, Bangor, Belco Pet., Boeing, Braniff, Bucyrus-Erie, Burndy, Central Fdy., Chi. Gr. Western, Chi. Nor. Western, Chris-Craft, Comb. Eng., Collins Radio, Cont. Cop. & Stl., Cresent Corp., Delta Airl., Emer. Rad., Fair. Cam., Fair. Hiller, Gen. Instr., Gulf & West Ind., Hallicrafters, Hoffman. Elect., Int. Resist., Leh. Val. Ind., Ling-Temco, Magnavox, Marquardt, Motorola, Packard Bell, Pitts. Coke, Raytheon, SCM, Spartans Ind., Sunstrand, Vendo, Vic-Comptometer, White Cons. Indus. This is the largest list I have ever seen (38) coming under the 50% rule, and it implies that the bulk of the recent speculative leaders are now in technically dangerous territory.

One segment of the market worthy of comment at this time is the "money groups" of stocks, the banks, finance companies, insurance, savings & loan and small loan groups. All of these groups "topped out" over a year ago, undoubtedly because informed investors foresaw difficult conditions developing in the money market. I have included charts of six of these groups (courtesy of Indicator Chart Service, Palisades Pk., N.J.), and it is evident that the downward trend in the money stocks has accelerated or renewed over the past few months. Remembering that a large portion of the retail sales of the nation are "financed" (i.e., purchased on credit), it would be well not to underestimate the bear trends in these important money groups.


LIFE INSURANCE
SAVINGS & LOAN ASSOCIATIONS
NEW YORK CITY BANKS
BANKS OUTSIDE NEW YORK CITY
FINANCE COMPANIES
SMALL LOANS
J F J A S O N D J F M A M J J A S O N D
66
64 65
65

LATE NOTE: In the realm of the strictly theoretical, I believe the following may be of interest. I have called attention in the past to the fact that important movements often occur in 5 waves (3 movements in the direction of the trend, 2 against the trend). Such movements also may follow within well defined channels. With this in mind, it is of interest that the broad S & P 500 Average appeared to have completed a five leg movement in mid-October and subsequently it broke out of the channel in which it had held since mid-July. Such action has often terminated important advances or declines. This is, of course, completely theoretical, and market students will immediately recognize such analysis as part of the Elliot Wave Theory. Although the validity of the Wave Theory is often (unfortunately) tested in retrospect, I felt the accompanying chart would be of interest.